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A Practical Guide for Construction Creditors in a Bankruptcy

As the structure of the U.S. economy changes in response to COVID-19, many bankruptcy filings are affecting the construction industry. At its core, federal bankruptcy laws are about debtor rehabilitation and fair and efficient treatment of the debtors' liabilities. However, often those doing business with a company that declares bankruptcy are left by the wayside due to the hurdles and confusing procedure that accompanies a bankruptcy.

Most of the literature on this topic is "debtor focused," meaning that it explains what to do to prepare if *your* company is filing bankruptcy. However, there is little practical guidance for contractors that are financially healthy but face a situation in which a customer, subcontractor, or vendor is entering bankruptcy. Completing a project on time while one of your vendors or subcontractors has just entered bankruptcy can be tricky for contractors that do not know the bankruptcy rules.

This article offers a practical explanation of how bankruptcies work, what common pitfalls arise for contractors if their customer or vendor enters bankruptcy, and how to handle these situations quickly and efficiently. It will also provide practical considerations and an understanding of bankruptcy in general terms. However, be mindful that there is usually a substantial interplay between bankruptcy law and substantive state law on issues that vary by jurisdiction (e.g., commercial and contract law, mechanic's liens, and claims against company management). Be sure to check with your legal counsel on matters discussed in this article.

Automatic Stay

When a bankruptcy is filed, much of the debtor's world comes to a halt, and an orderly process is attempted to address the debtor's obligations in a way that preserves the value of the debtor's business or assets. Thus, a bankruptcy ***automatic stay,*** which has the force of a federal court order, prevents creditors from engaging in collection actions or lawsuits against the debtor, contract terminations, and any actions that may be adverse to the property of the bankruptcy estate.[1] It even prevents mechanic's liens from being filed in certain states.[2] For example, according to *In re Draper*, sending informational invoices with a return payment envelope is a violation of the automatic stay.[3]

In the normal creditor-debtor scenario, the automatic stay is an inconvenience and one of many disappointing events in a commercial relationship in which one party has performed its obligations and the other party has not. But, in construction, consequences may be more urgent. You may have performance obligations on an existing construction project, face delays as well as liquidated damages, experience shortages in available labor or material, or encounter work orders that have a long lead time. Finding out that one of your project partners is not going to perform requires a swift response.

Bankruptcy Basics

When a debtor files for bankruptcy under the Bankruptcy Code, it chooses between reorganization (Chapter 11) and liquidation (Chapter 7). In a reorganization, the debtor's management usually stays in control of the business. They are given time to propose a plan that would allow the bankruptcy debtor to pay certain minimum thresholds to its creditors. The company would then emerge from the bankruptcy as a reorganized company that is unburdened by many of the pre-filing obligations. In a liquidation, a bankruptcy "trustee" is appointed by the court to sell and distribute all assets of a company to creditors.[4]

This distinction is important if you have contracts with a bankrupt entity; usually, if the debtor is attempting to reorganize, then it will have some plans in place to continue performing under its contracts. After all, what will be left to reorganize if the debtor loses the confidence and trust of all of its customers and key vendors during the bankruptcy process? In a liquidation, the motives and interests of the debtor are not as much about preserving a future business as they are about an orderly wind-down.

However, not all Chapter 11 filings have a reasonable hope of successful reorganization. Because an "11" can always be

later converted to a "7," it is not unusual that a case may be filed as an "11" merely for the added benefit that the debtor stays on as management for the initial stages of the bankruptcy. Owners of construction companies have a business concern that most other business owners do not have — personal liability in the form of an indemnity (or personal guarantee) on their performance and payment bonds and perhaps some of their supplier agreements. There are benefits to company owners staying on as management through the initial stages of a bankruptcy — some of which have nothing to do with the actual reorganization.

First Day Filings/Schedule of Assets & Liabilities

The first day of a bankruptcy is often the most telling in terms of assessing the debtor's intentions toward pre-petition obligations. A well-organized set of bankruptcy filings is an indication that the debtor will truly reorganize. A "crash landing" filing that lacks any indication of advance planning likely signifies no real path toward reorganization, even if the debtor commences the proceeding as a Chapter 11 reorganization.

Exhibit 1 presents some common and useful examples of what may be included in first day filings and what that tells about the debtor's plans.

Supplementing, Descoping, or Back Charging a Non-Performing Bankruptcy Debtor

The fact that a debtor files bankruptcy is not grounds to terminate a contract, regardless of your contract terms.[5] With that being said, construction contracts typically provide rights to supplement, accelerate, and issue change directives, including the right to "descope" a lower-tier contractor. These provisions generally survive a bankruptcy filing, and a non-debtor is permitted to the benefit of contract terms that do not violate bankruptcy principles.

Violating the Automatic Stay

Typically, the mere act of supplementing or issuing a change directive will not violate the automatic stay. But be mindful of the fine line between continuing performance under a contract and taking actions that affect property of the bankruptcy of the estate in violation of the automatic stay.

For example, as displayed in *In re Sixteen to One Mining Corp.*, the notice of default on a lease was not a violation of the automatic stay so long as it did not demand possession (9 B.R. 636 (Bankr. D. Nev. 1981)). Make sure to get the advice of legal counsel that understands bankruptcy and construction law so you don't unintentionally violate the automatic stay.

Exhibit 1: First Day Filing Examples

First Day Filing	What It Is & What It Can Tell You About the Debtor
Schedule of Assets & Liabilities[1]	This is an attachment to the bankruptcy petition that shows the magnitude of the debtor's assets and expected income compared to outstanding debts. This can show how many creditors are unpaid and in what amounts. You can learn a lot about a company by studying this information.
First Day Affidavit	Some jurisdictions require bankruptcy filings to be accompanied with an affidavit from the debtor explaining the debtor's business, its key contracts, and why it needs bankruptcy relief as well as to set out some of the hurdles that the debtor anticipates.
Motion to Authorize Use of Cash Collateral[2]	This is how the debtor requests use of cash that may be encumbered by the security interest of its lenders for ongoing operational expenses. This motion will typically lay out why the lender's interest in collateral is protected by the continued use of it, why the use of the cash protects the overall interest of the estate, the details that can give a view into the debtor's business, and its intentions.
Critical Vendor Motion[3]	A critical vendor is a bankruptcy debtor's way of treating certain creditors' claims as being higher priority, meaning creditors that the debtor must pay in order to continue operations. A GC, for example, will often list its key subcontractors for projects it intends to complete. The information that the debtor must provide to obtain court approval to make priority payments will tell you a lot about the debtor's intentions.
Motion to Pay Pre-Petition Wages[4]	This is exactly what it sounds like — the bankruptcy debtor asking for permission to make sure that any wages earned before the bankruptcy is filed may be paid. A reorganizing debtor concerned with its future business will need to keep key employees in place, and one indicator of this intention is to show that they are being retained.

Endnotes:
1. *In re Analytical Systems, Inc.* 933 F.2d 939 (11th Cir. 1991); 11 U.S.C. §1111; Rule 3003(c)(2).
2. 11 U.S.C. §362; 11 U.S.C. §363; F.R.B.P. 4001(b).
3. 11 U.S.C. §105; 11 U.S.C. §363; 11 U.S.C. §364(b).
4. 11 U.S.C. §105; 11 U.S.C. §363; 11 U.S.C. §364(b); 11 U.S.C. §507(a)(5); 11 U.S.C. §541(d).

Back Charge

A little closer to the automatic stay is the formalization of a back charge after you have supplemented a lower-tier contractor. It may seem like a distinction without a difference that you can more easily supplement than back charge, but the act of taking or asserting a claim to funds that the debtor had earned infringes on the automatic stay's prohibition against actions that affect property of the estate.

Where the back charges are asserted per your contract and deducted from any retainage or payments due on the *same project*, asserting contractual back charges is generally allowed so long as the back charges do not exceed the contract balance. As displayed in *In re Izaguirre*, a party need not seek relief from the automatic stay to assert the right to recoupment, but "the better approach is to seek relief from the stay as a precaution" (166 B.R. 484, 493 (N.D. Ga. 1994)). However, if a contractor has multiple contracts with a debtor or if the contract does not have a well-defined back charge provision, then permission from the bankruptcy court is necessary before applying back charges — even if your contract has language allowing deductions across all active projects.[6]

In these situations, it is typically advised to only go as far as necessary to preserve the status quo. Then, if there are back charges at the end, work those out through a settlement that is approved by the bankruptcy court. For smaller back charge amounts, no one is likely to kick up any dust; but, if the debtor claims a substantial receivable and the back charge is disputed, then being overaggressive in the face of the automatic stay can be a costly mistake.

The Debtor's Option to "Reject" a Contract

Be mindful that, while a non-debtor cannot terminate a debtor merely by virtue of the debtor having filed for bankruptcy relief, a debtor has the option to wholesale "reject" any contract where both parties have ongoing obligations. As displayed *In re Central Florida Metal Fabrication, Inc.*, a contract is "executory" and can be rejected if it has not yet been substantially performed by both sides (190 B.R. 119 (Bankr. N.D. Fla. 1995)). A debtor typically specifies which contracts are being assumed or rejected as part of the reorganization plan.[7] It is not a violation of the automatic stay to ask the debtor's intentions regarding moving forward with your contract.

For example, according to *In re Epperson*, informational requests are not a violation of the automatic stay where the communication with the debtor is not threatening or harassing (189 B.R. 195 (E.D. Mo. 1995)). If you do not receive a clear answer from the debtor and the answer has a significant financial impact, you can compel an answer through the bankruptcy court.[8]

As discussed in *Aslan v. Sycamore Investment Co.*, a rejection is treated as a pre-petition breach by the debtor, meaning that the non-debtor has a breach of contract claim that will be treated as an unsecured claim worth only pennies on the dollar (909 F.2d 367 (9th Cir. 1990)). This is not ideal, but for planning purposes, it is better to know the debtor's intentions sooner rather than later.[9] A debtor is fully responsible for new business that is post-petition (i.e., after the company files for bankruptcy), but you still need to assess whether the debtor is a worthy credit risk before undertaking any new business with that debtor.

Retainage & Outstanding Payment Applications at Time of Petition

When a debtor-contractor files for bankruptcy, it will likely include retained amounts earned under ongoing contracts among its assets. However, whether retainage is the property of the bankruptcy estate differs among states. This is based on your state's view of particular contract provisions that govern when funds are "owed" under the contract, such as pay-if-paid provisions, payments to subcontractors, and submission of lien waivers before receiving payment.[10] This distinction can become important in cases where there are unpaid lower-tier vendors that are requesting direct payment or in the case of a surety taking over for debtor's default.

Some jurisdictions have created a "constructive trust" doctrine to allow creditors to pay lower-tier vendors directly and bypass payment to the bankruptcy estate. For example, in *Bethlehem Steel Corp. v. Tidwell*, a constructive trust doctrine was applied but only so far as the downstream supplier's lien rights (66 B.R. 932 (M.D. Ga. 1986)). The *Bethlehem Steel* court based its holding on Georgia law and its long line of precedent affirming the constructive trust theory. If possible, using your contract provisions to require joint checks or direct payment to lower-tier subcontractors if bankruptcy is impending can minimize the risk of lower-tier subcontractor liens or work stoppages on a continuing project. Make sure to seek guidance from your company's attorney before proceeding.

Preserving Claims Against a Debtor

While much of this article has to do with navigating a continuing relationship with a bankruptcy debtor, it's important

to know the basics of the bankruptcy claims process, which are not always immediately clear.

Presenting a Proof of Claim

For your typical unsecured claim, you should receive notice of a "claims bar date" that will provide a deadline for the submission of any "proofs of claim." This is the opportunity for a creditor to file a document — and attach any unpaid invoices or supplementation charges — that informs the bankruptcy court of outstanding amounts owed by a debtor.

If the debtor does not dispute the proof of claim, the documentation submitted will determine the amount of a claim, keeping in mind that most bankruptcies pay out a percentage of unsecured claims. As displayed in Rule 3003(c)(2), many courts accept electronic proof of claim submissions and do not need them to be submitted by an attorney.[11]

Additional Rights of Material Suppliers

Suppliers of goods have additional tools to ensure that they are paid by a customer that has filed bankruptcy. For example, a supplier may demand "adequate assurance" that it will be paid for the goods supplied, and if the debtor does not promise to pay for the materials, then a supplier can stop delivery.[12] This demand for assurance of payment can be coupled with a "reclamation demand," which sends a demand to the customer that they must return any goods delivered.

According to 11 U.S. Code §546(c)(1), this demand must be filed within 45 days of goods being delivered (or 20 days of the bankruptcy filing if the bankruptcy is filed during the 45-day window), identify the specific goods, and include the specific delivery date and value of the goods.

This encourages the debtor to pay for the goods rather than going to the bankruptcy court to sort out whether they are required to return materials. Be aware that some courts require the reclamation demand to be filed as an objection in the bankruptcy, so if the debtor does not respond to your reclamation demand letter quickly, then you will need to assess if the value of the goods is worth requesting that a lawyer look into whether an objection is necessary.

Finally, a material supplier receives priority to be paid first in line for any materials delivered within 20 days of the bankruptcy filing as an "administrative expense claim."[13] If you have delivered materials to a job within 20 days of the bankruptcy filing, then make sure to file a separate "§503(b)(9) claim" for the value of recently delivered materials, as this can significantly increase your recovery in the bankruptcy.[14]

Preserving Lien Rights

A contractor's lien rights are a powerful tool to secure payment. However, whether filing a lien after an owner or higher-tier contractor has filed for bankruptcy is a violation of the automatic stay depends on how a state defines its lien law. In states where filing a lien relates back to the time in which work is first performed, filing a lien does not violate the automatic stay. However, in states where a lien is not created until a notice of lien is filed, a contractor must request permission from the court to file a lien or file a notice of the lien directly with the bankruptcy court.[15] It's best to discuss this with your legal counsel before filing a lien when a higher-tier party to a construction project has filed for bankruptcy relief.

Bond Claims & Personal Guaranties Circumvent Some Bankruptcy Complications

For contracts secured by a payment and performance bond or a personal guaranty, claims can be asserted directly against a surety or guarantor even if the principal is in bankruptcy.[16] Sureties (and occasionally personal guarantors) often have rights to receive notice before supplementation occurs, so it is a best practice to check any applicable bonds when a debtor declares bankruptcy. This will help ensure that the confusion of a bankruptcy doesn't create additional issues with a surety.

Voting on the Plan of Reorganization

In a Chapter 11 reorganization, all creditors that are not expected to receive the full value of their claim will be presented with a copy of the debtor's plan of reorganization and a ballot to vote to accept or reject the plan.[17] The vote is to tell the court whether creditors approve the plan as fair to them. Common reasons to reject a plan include if a debtor's ownership is receiving an excessive financial benefit or if the creditors would be better off if the debtor's assets were liquidated.

Preference Actions

Be aware that the bankruptcy code includes policies aimed at making sure no creditor receives preferential treatment, which leads to mechanisms for a bankruptcy trustee to essentially take back certain payments made within 90 days of the bankruptcy filing.[18] In other words, if you received payment in the 90 days pre-petition, you may get sued by the bankruptcy trustee for return of that payment.

Fortunately, many payments to contractors will fall within an exception to this preference rule based on payments made in the ordinary course of business or related exceptions to preference actions, so long as payment is being made according to the contract payment provisions.[19] In many states,

providing a lien waiver constitutes an exchange of fair value for payment and can take a payment outside of the trustee's powers to avoid a payment. The concept is that a creditor shouldn't be incentivized to refuse payments from higher-tier subcontractors and file liens if the creditor suspects its customer is headed for bankruptcy.

Conclusion

Bankruptcy is a complicated process — one that even confuses lawyers who do not regularly practice bankruptcy law. It is also frustrating for contractors that are not prepared for the realization that unsecured creditors often recover very little of the amounts they would be entitled to under a contract and end up writing off the difference as bad debt.

A contractor with a general understanding of the bankruptcy process is in a better position to set realistic expectations and control the process to minimize the impact on any ongoing projects. ■

Endnotes

1. 11 U.S.C. §362.
2. *Compare in re Linear Electric Co., Inc.*, 852 F.3d 313 (3d Cir. 2017) (under New Jersey lien law, a lien is not perfected until the lien is filed and served [as opposed to many states where a lien relates back to the date of the work], thus a lien filed after a bankruptcy was a violation of the automatic stay); *with in re James A. Phillips, Inc.*, 29 B.R. 391 (S.D.N.Y. 1983) (because lien "relates back" to pre-bankruptcy under New York lien law, a lien fell within the exception to the automatic stay [11 U.S.C. §546(b)] allowing a creditor to protect its lien rights).
3. *In re Draper*, 237 B.R. 502 (Bankr. M.D.Fla. 1999) (Creditor violated automatic stay when it had knowledge of debtor's bankruptcy and repeatedly sent debtor informational invoices with a return payment envelope).
4. 11 U.S.C. §701 et seq.; 11 U.S.C. §1107.
5. 11 U.S.C. §541(c); 11 U.S.C. 365(e).
6. 11 U.S.C. §553.
7. 11 U.S.C. §1123(b)(2).
8. A contractor may file a motion with the court to force the debtor to assume or reject a contract so that the contractor can supplement without worry of violating the automatic stay. 11 U.S.C. §365(d)(2).
9. Rule 3002(c)(4) (claims for rejection damages to be filed "within such time as the court may direct"). Some courts have local rules that govern when a claim for rejection damages must be filed, while others will set a "bar date" on a case-by-case basis. For example, D.N.J. LBR 3003-1 requires a claim for rejection damages within 30 days after the date of rejection.
10. *In re Modular Structures, Inc.* 27 F.3d 72 (3d Cir. 1994) (finding that the estate did not have a claim to retainage where the debtor failed to meet the contractual conditions precedent to payment of paying its subcontractors under the contract and the surety completed the contract); *In re QC Piping Installations, Inc.* 225 B.R. 553 (Bankr. E.D.N.Y. 1998).
11. Fed. R. Bankr. P. 3003. Most federal district bankruptcy courts also have local rules about proofs of claim.
12. Restatement (Second) of Contracts §251. U.C.C §2-609.
13. 11 U.S.C. §503(b)(9).
14. Where you provide both materials and installation, the court will separate out the value of the goods installed from the labor. For example, a heating, ventilation, and air conditioning (HVAC) contractor would be entitled to full payment for a unit, but the value of the labor would be lumped together with the other "general unsecured claims." *In re Plastech Engineered Products, Inc.* 397 B.R. 828 (Bankr. E.D. Mich. 2008).
15. *Compare In re Durango Georgia Paper Co.*, 356 B.R. 305 (Bankr. S.D. Ga. 2005); *with In re Linear Elec. Co.* 852 F.3d 313 (3d Cir. 2017); 11 U.S.C. §546(b)(2).
16. *Bonjour, Gough & Stone v. Pacific Employers Insurance.* 503 F.2d 618 (9th Cir. 1974).
17. 11 U.S.C. §1126.
18. 11 U.S.C. §547.
19. 11 U.S.C. §547(c).

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